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**Macroeconomic policy questions: external debt crisis and development**

# Recent developments in external debt

## Report of the Secretary-General

*Summary*

The present report, submitted in compliance with General Assembly resolution 60/187, contains a review of the recent developments in the external debt of developing countries, against the backdrop of favourable global market conditions. It also contains analyses of the implementation of the Heavily Indebted Poor Countries and Multilateral Debt Relief Initiatives and the financing problematic for low-income countries. The policy conclusions address the challenges related to private debt flows and to the financing of development in low-income countries.

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# I. Introduction

1. The present report is prepared for the consideration of the General Assembly, in compliance with the request made by the Assembly in paragraph 26 of its resolution 60/187. It contains a review of the implementation of the resolution in the light of a comprehensive and substantive analysis of the external debt of developing countries.

# II. Recent trends in external debt

2. The total external debt of developing countries in 2005 is estimated at $2.8 trillion, an increase of 1.6 per cent as compared with 2004 (the lowest rate of growth since 2000). As gross national income (GNI) in nominal dollar terms for the group of developing countries as a whole was growing at a rate far exceeding 1.6 per cent in 2005, the ratio of total external debt to GNI would be below 34 per cent, the level reached in 2004. Likewise, buoyant exports would bring down the ratio of debt to exports to below 88 per cent, the level reached in 2004.

3. The significant slowdown in the accumulation of external debt was due primarily to a decrease in the stock of debt of Latin America and the Caribbean as a result of debt renegotiations involving debt reductions and debt buy-backs or prepayments. Sub-Saharan African countries also had their stock of debt reduced, mostly as a result of the implementation of the Heavily Indebted Poor Countries (HIPC) Initiative.

4. Factors which contributed to the improvement in the external debt position of developing countries are manyfold. First, favourable conditions characterizing the global economy since the beginning of the decade enhanced the export performance of developing countries and significantly lowered their cost of borrowing on capital markets. Secondly, the composition of external capital flows to developing countries has evolved towards more reliance on non-debt creating flows, mostly foreign direct investment (FDI). Lastly, developing countries increasingly switched to domestic debt as a source of finance for the public and private sectors.

5. Most notable was the remarkable improvement in the current account of developing countries owing to their export performance. Since 2000, developing countries have been running a current account surplus that keeps growing every year (the estimated surplus in 2005 is five times higher than the surplus in 2000). Of all the regions, East Asia accumulated the highest surplus, followed by the Middle East and North Africa. Accompanying the current account surpluses was a significant increase in the stock of foreign exchange reserves held by developing countries, which reached $2 trillion by the end of 2005. Reserve build-ups result mainly from foreign exchange interventions to minimize the impact of inward flows of foreign exchange on exchange rate appreciations. There is also an implicit willingness to build up reserves as an insurance against future fluctuations of capital flows. Over the last three years, many debtor countries used their reserves or borrowed on favourable conditions on capital markets to repay their debts to the Paris Club, buy back their Brady bonds or extend the maturity of bonds through bond exchanges. The availability of liquidity thus allowed debtors to implement an active debt management strategy to reduce the stock of debt, lower its cost and extend its maturity.

6. At the same time, the composition of capital flows to developing countries has fundamentally changed. Private flows increasingly represented the bulk of net capital flows and FDI, as a non-debt creating flow, has become the largest source of external capital (almost 80 per cent in 2005). Likewise, net debt flows are predominantly of private origin, as flows from official creditors became increasingly negative since 2003.[1]

7. The reduction in external debt was compensated by an increase in domestic debt in all regions. Domestic debt has steadily grown over the last 10 years, alongside the development of domestic debt markets in developing countries. The switch from external to domestic debt was the most pronounced in Asia, resulting from a rebalancing of debt in the aftermath of the 1997-1998 financial crisis. The ratio of domestic to external debt in that region rose from 1.0 in 1997 to almost 3.0 in 2002.[2] In Latin America, the ratio of domestic to external debt also rose from 1.35 in 1997 to 1.54 in 2002, with Mexico and Brazil holding the largest shares of domestic debt.[3] In the Middle East and North Africa, domestic debt rose from 18 per cent of gross domestic product (GDP) in 1995 to 47 per cent in 2002.[4] In sub-Saharan Africa, excluding South Africa, domestic debt grew from 11 per cent of GDP in the early 1980s to 15 per cent by the end of the 1990s.[5]

8. While the overall external debt situation of developing countries as a group looked much improved, this masks the debt problems faced by individual countries or groups of countries. Many middle-income countries in Latin America, Asia and Eastern Europe still have very high ratios of external debt to GDP, while running large current account deficits. Other countries whose debt levels appear manageable are rapidly accumulating debt because of persistent current account deficits. For the low-income countries in sub-Saharan Africa, the solution to their financing problems does not seem to be within reach. Many of the heavily indebted poor countries that have reached completion points have seen their indebtedness increase dangerously and about half of eligible countries have yet to benefit from debt relief under the HIPC Initiative.

9. Moreover, many of the favourable conditions in the global economy which have supported developing countries' growth over the last five years risk being reversed in the near future. The continuing rise in oil prices can ignite inflation which may trigger interest rate rises in the major countries of the Organization for Economic Cooperation and Development (OECD). In the most vulnerable oil-importing countries, current account deficits may worsen, entailing significant increases in external debt. The adjustment to global imbalances may induce increases in interest rates and, consequently, a rebalance of investors' portfolios towards mature markets at the expense of developing countries. This would also put an end to the historically low levels of bond spreads for developing country borrowers. A disorderly resolution of global imbalances might reduce global growth and weaken non-oil commodity prices and export performance of developing countries, as well as their capacity to service debt.

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[1] Net official debt flows on long and medium term amounted to -$12.3 billion in 2003, -$28.7 billion in 2004 and -$71.4 billion in 2005.

[2] World Bank, *Global Development Finance 2005* (Washington, D.C., 2005), p. 78.

[3] Ibid., p. 80.

[4] Ibid., p. 86, footnote 7.

[5] Jacob Christensen, "Domestic Debt Markets in Sub-Saharan Africa", in *IMF Staff Papers* (Washington, D.C., International Monetary Fund, 2005), vol. 57, No. 3, pp. 518-538.

10. Finally, another risk might come from the servicing of an ever-increasing stock of FDI. Indeed, profit remittances from FDI are taking up a larger share of current account income payments from developing countries. In 2005, profit remittances represented 57.3 per cent of total income payments, exceeding by far interest payments on debt. Profit remittances are on a rising trend, growing annually by 11 per cent since 1980 (as compared with 4 per cent in the case of interest payments). This could exert pressure on the current account of host countries, especially in situations where FDI is mostly geared towards domestic rather than export markets.

# III. Bonds debt

## A. Foreign currency bonds

11. The composition of external long-term debt has also changed significantly. Bonds have assumed increasing importance, as the volume of international bond issuance by developing countries more than doubled between 2001 and 2005. Debt flows from commercial banks which turned negative in the aftermath of the Asian financial crisis have also resumed strongly during the last two years.

12. Although still concentrated within a relatively small number of borrowers, the distribution of bond and bank finance has become more diffused over the last two years. Access to the bond market remained more restrictive and is conditional on investment-grade rating by the recognized credit rating agencies. Traditionally, the cost of bond borrowing exceeded that of bank borrowing; however, the cost difference narrowed substantially in 2005 owing to the historically low levels of bond spreads and of the underlying benchmark long-term rate. Accommodative monetary policy in major OECD countries supported an environment of ample liquidity and low interest rates in global financial markets. For example, the average yield on the 10-year United States Treasury bond decreased from 6.0 per cent in 2000 to 4.0 per cent in 2003 and 4.3 per cent in 2005. During that period, interest rates also declined in the euro-zone and in Japan.

13. The low levels of bond spreads for emerging markets reflected their enhanced creditworthiness, which was driven by the improvement in a number of key economic indicators, such as stronger current account positions, lower fiscal deficits and improved regulations of domestic financial markets. Emerging market borrowers issued $182 billion in bonds in 2005, compared to $89 billion in 2001.

14. The large aggregate issuance of new bonds was accompanied by structural improvements in the external debt position of emerging markets, as a few countries[9] prepaid large portions of their external debt, mainly through the repurchase of Brady bonds, and improved the maturity structure of their debt portfolio through the issuance of longer-maturity bonds. The combination of lower borrowing costs, a better maturity structure of debt portfolios and a strong growth performance resulted in credit rating upgrades for a large number of emerging markets. This has further broadened the investor base, opening the way for pension funds and insurance companies from developed countries to increase the share of emerging market debt in their portfolios.

[9] Brazil, Colombia, the Bolivarian Republic of Venezuela and Turkey.

15. The increase in the outstanding stock of bond debt during the period 2003-2005 has largely been driven by the issuance of new bonds by the emerging markets' corporate sector, primarily in Eastern Europe, Latin America, South Asia and South Africa. Governments need to watch closely their private sector's borrowing in order to avoid the risk that corporate borrowing become contingent liabilities for Governments in the future. In the aftermath of the Asian crisis those contingent liabilities were very costly for Governments.

16. The sustainability of the recent trends needs to be assessed against the background of the global shift towards more restrictive monetary policies in the second quarter of 2006 and the waning of investors' risk appetite. Although the sustainability of emerging market borrowers does not seem to be at risk at present, the debt servicing burden for developing countries is likely to increase next year, as the maturing bonds will need to be rolled over against new issues carrying a higher coupon.

17. The high (negative) correlation between flows to emerging markets and interest rates in developed markets, in particular the United States interest rates, has already been observed during the previous cycles. The data on emerging market bond issuance for the latter part of 2005 and early 2006 would seem to indicate that some borrowers have anticipated the likelihood of higher interest rates and yield spreads for the period 2006-2007. In some instances, sovereign issuers have taken advantage of the low borrowing costs in 2005 and early 2006 to pre-finance their borrowing needs up to six months in advance, thus capping their debt servicing at lower levels than they would have been had the bonds been issued at a later stage. If the additional data on borrowing practices by sovereigns for the period 2005-2006 confirms that there was a conscious strategy of issuing in advance to hedge the risk of interest rate increases, it would indicate a growing sophistication of developing countries in managing their external debt portfolio with a view to reducing vulnerability to cyclical changes in global monetary policies.

18. Attention has recently been given to the use of GDP-indexed bonds to address the procyclicality problem of capital flows. In order for borrowers to benefit fully from GDP-indexed bonds, such bonds should contain a clause for linking debt servicing to the level of economic activity, such that in times of high growth and high government revenues, debt servicing would be higher, whereas the opposite would hold during recessions. However, the recent experience of countries that have issued GDP-indexed bonds[7] shows a different structuring of those instruments, where debtors issued bonds with attached warrants giving investors the right to obtain higher payouts if GDP growth exceeded a certain threshold, but there was no mechanism for diminishing payments below the original coupon if GDP growth dropped below some predetermined level. Although it could be argued that investors are willing to accept a lower initial coupon if there is an attached option for higher payouts in the event that economic performance is strong in the future, there is no empirical evidence to support that argument. In particular, at a time of rising global interest rates, investors' expectations of future global GDP growth are revised downwards, lowering the value of options linking higher payouts to higher GDP growth, therefore reducing the attractiveness of such bonds to potential buyers. Further complicating the possibility to expand the use of fully GDP-linked bonds are the recognized difficulties of pricing such instruments (besides statistical

[7] Argentina in the aftermath of the debt restructuring in 2005 and Bulgaria in 1994.

problems of measuring GDP), not only at the time of issue, but also, in particular, during the lifetime of the bond. Such pricing difficulties could limit the possibility of creating a buoyant secondary market for such instruments, therefore limiting the liquidity of such bonds.

## B. Domestic currency bonds

19. The local currency bonds markets have also rapidly expanded, although the depth, liquidity and type of instruments traded in those markets differ greatly between regions. In sub-Saharan Africa, bonds issued by Governments are of short maturity and carry higher interest rates than international loans. The rollover risk could create deep crisis for Governments if failure to refinance the debt obligation leads to expenditure cuts. Moreover, given that the investor base in sub-Saharan Africa is very narrow and dominated by commercial banks, private enterprises risk being crowded out from loan markets.

20. In Asia and Latin America, the stock of local currency bonds has increased more than fourfold in the last 20 years. This has been supported by increased depth and liquidity in the local capital markets, while the maturity profile of the debt is estimated to be seven times longer than in sub-Saharan countries. The investor base in Asia and Latin America is much broader than in Africa, with a large number of domestic institutional investors actively participating in the debt market. The steady improvement of emerging market credit ratings as well as the strong current account position of commodity exporting countries has attracted international investors willing to purchase domestic currency bonds, thus further broadening the investor base. Besides the benefits of raising funds in the domestic currency, allowing foreign participation improves the breadth and depth of the local capital market and is likely to lead to the improvement in business practices under the pressure from foreign investors to raise the level of transparency and efficiency in line with international practices. However, large and unrestricted flows of capital into local markets may limit the Government's ability to channel foreign purchases into the longer segment of the maturity curve, which could lead to the bundling of investments on the short end and increase rollover risks in the event of a sudden liquidity drawdown. The recent change in the international interest rates and increased investors' risk aversion point to some of those risks, as it has recently been reported that some outflows of investment from emerging markets have induced currency depreciations.

21. In some countries that apply financial or administrative disincentive measures with regard to foreign participation in domestic markets, Governments have opted for the issuance of local currency bonds in the international capital markets. Such a policy gives international investors access to higher yields and issuing countries the protection against currency risk, while calibrating the maturity structure of the debt held by foreign participants. Moreover, a sudden closure of positions by investors will have no impact on the exchange rate, as bonds will be sold to other foreign investors. However, the disadvantage of issuing local currency bonds in international markets is that there are no benefits for the development of domestic capital markets that are usually associated with the active involvement of foreign investors. Several Latin American countries (Colombia and Brazil in particular) and the Russian Federation have issued large amounts of bonds denominated in local currency in the international capital markets.

## C. Credit rating agencies

22. The new financial architecture of the twenty-first century is dominated by private investors and credit rating agencies are likely to play a critical role, as they hold the key to access the private capital markets.[8] The role of credit rating agencies has recently received a boost from regulators in the context of the ongoing revision of the Basel minimum capital requirements for banks by the Basel Committee on Banking Supervision, culminating in what is now referred to as Basel II, which grants the agencies an explicit role in the determination of risk weights on bank lending.

23. Credit rating agencies, by expressing "opinions" on the creditworthiness of borrowers based on information gathered and analysed by those agencies, assist investors in solving the informational asymmetry vis-à-vis borrowers. Their "opinions" exert a powerful influence on the decision by investors to invest in instruments issued by borrowers that have received "investment grades" and to lower the lending spreads on bonds issued by "good" clients. Credit rating agencies have contributed, at times, to deepen the booms and busts of capital flows.

24. Although the investment community and borrowers, either sovereign or corporate,[9] accept the credit rating agencies' role as "opinion makers", not much is known about the methodologies used by such agencies to assess borrowers' creditworthiness and the probability of default. In trying to identify the determinants of ratings and the variables used by credit rating agencies, economists and external observers found that the agencies generally use economic variables which are divided in three categories: (a) measures of domestic economic performance; (b) measures of a country's external position and its ability to service its external obligations; and (c) the influence of external developments. Overall it is found that credit rating agencies lack transparency and their methodology is opaque. The critical role of the agencies in addressing the problem of information asymmetry would require that rating methodologies be made more transparent.

25. Another concern is that countries may implement policies that address rather the short-term concerns of portfolio investors in order to avoid a downgrading of their rating, while not necessarily taking into account their long-term development needs (for example, by applying restrictive monetary policies to increase interest rates during periods of economic slowdown or slack of investment). A better understanding of variables and policies underlying a rating grade could initiate a constructive dialogue between borrowers and investors and contribute to develop a longer-term view on the enabling conditions for investment. Transparency would also help to redress failures, as it was found that the predictive power of ratings has not always been infallible on many occasions.[10]

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[8] The present section is based on an analysis contained in a paper prepared by UNCTAD: "Rating the Credit Rating Agencies and their Potential Impact on Developing Countries", forthcoming. The paper is prepared pursuant to paragraph 13 of General Assembly resolution 60/186 on the "International financial system and development".

[9] In order to issue bonds on international capital markets, sovereign and corporate borrowers need to obtain a rating from credit rating agencies.

[10] In the event of the Asian financial crisis, both credit rating agencies and markets failed to predict the crisis. Likewise, the recent Enron and WorldCom bankruptcies have revealed important shortcomings of the credit rating system.

26. Another issue raised by the current rating system is the lack of competition, as the system is dominated by two major agencies (Moody's and Standard and Poor's) and one smaller player (Fitch). Although lack of competition may be due to factors related to the reputation, credibility and consistency of the credit rating agencies to which users attach importance, regulatory restrictions in capital market countries may have played a role.[11] The question is whether increased competition between a greater number of agencies would produce the desirable effects of reducing the cost and enhancing the transparency and accuracy of ratings.

27. The question of accountability has also been raised. Despite the enormous influence exerted by credit rating agencies, it is not clear to whom the agencies are accountable. To some extent, it can be argued that the interests in preserving reputation and credibility are incentives to generate quality financial information. Nevertheless, the International Organization of Securities Commissions has issued a Code of Conduct Fundamentals for Credit Rating Agencies, focusing on: (a) the quality and integrity of the rating process; (b) agency independence and the avoidance of conflicts of interests; (c) agency responsibilities to the investing public and issuers. This can be considered as a useful first step to "codify" the practices of credit rating agencies.

# IV. Paris Club debt renegotiations

## A. Recent cases

28. During the period from mid-2005 to mid-2006, there were eight Paris Club meetings, four for HIPCs and four for non-HIPCs. In September 2005, Burundi reached the decision point and was granted interim relief under Cologne terms. Also in September 2005, a renewed agreement granting Cologne terms was reached for Sao Tome and Principe, which had reached the decision point in 2000, but had its International Monetary Fund (IMF) programme derailed in 2001. In March 2006, the Congo's debt was treated under Cologne terms after it had reached its decision point. Cameroon reached its completion point in April 2006 and received, in June 2006, a substantial reduction of almost 100 per cent of its Paris Club debt.

29. The other four meetings treated the debts of the Dominican Republic and Grenada under classic terms, Moldova under Houston terms, and Nigeria, which obtained ad hoc treatment.

30. The Nigerian case has a number of unique features. It is the first country to use the newly established Policy Support Instrument of IMF, which permits the Fund to monitor a country's economic reform process in the absence of an IMF lending programme. Nigeria is also the first country that successfully incorporated Millennium Development Goals as part of its debt sustainability analysis. The agreement reached with the Paris Club has allowed Nigeria to be the first African country to exit the Paris Club through a combination of prepaying part of the debt and obtaining a debt cancellation on the remaining amounts. Under the agreement

[11] In the United States, for example, the Nationally Recognized Statistical Rating Organization (NRSRO) has, in fact, according to the United States Department of Justice, acted as a barrier to entry in a catch-22 manner: a new rating agency cannot obtain national recognition without NRSRO status without national recognition.

reached with Paris Club creditors, in the first phase, Nigeria cleared all its arrears to the Paris Club, amounting to $6.3 billion, and creditors cancelled 33 per cent of eligible debt. In the second phase, Nigeria paid all its post-cut-off date debt, creditors cancelled another 34 per cent of pre-cut-off date debt and Nigeria bought back the remaining amounts of pre-cut-off debt.

31. In 2006, up to the end of June, the following additional countries cleared at par their remaining debt with the Paris Club: Brazil (for $2.6 billion); Algeria (for $7.9 billion); and the Russian Federation (for $22 billion).

### B. Debt swaps

32. The Paris Club introduced the debt swap clause in 1990 for lower-middle-income countries under the Houston terms and extended it to low-income countries in 1991. The current limits on debt swaps within the Paris Club are 20 per cent of the outstanding amount, or up to SDR 30 million for non-official development assistance (ODA) credits,[12] and 100 per cent of ODA loans.

33. Paris Club debt conversions can be conducted either through direct agreement between the creditor and the debtor or indirectly through an intermediary investor (a non-governmental organization most of the time) which buys the debt at a discount. The problem with the second option is to agree on the discount: in the absence of the secondary market for such debt, it is difficult to determine the correct price. Most of the projects financed by Paris Club debt swaps are so far destined to environmental protection. It is to be noted that the debt swap clause has not been used up to the limits allowed, because of the lack of projects that can be funded. If an agreement could be reached to use debt swaps for the financing of projects helping debtors to reach Millennium Development Goals, it is expected that debt can be swapped up to the statutory limit, or beyond (as permitted by bilateral agreements).

## V. Debt relief for heavily indebted poor countries

### A. Progress under the Heavily Indebted Poor Countries and Multilateral Debt Relief Initiatives

34. During the first half of 2006, the Congo reached the decision point and Cameroon the completion point. For the period 2004-2006, only Burundi (August 2005) and the Congo (2006) had reached the decision point, reflecting a marked drop in progress with respect to the remaining countries that have yet to be considered under the Initiative. Thus far, only 19 countries,[13] i.e. less than half of those eligible, have reached the completion point under the enhanced HIPC Initiative and 10 HIPC countries[14] remain in the interim stage between decision and completion points under the Initiative.

[12] The debtor can choose the more beneficial option.

[13] Benin, Bolivia, Burkina Faso, Cameroon, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, the Niger, Rwanda, Senegal, Uganda, the United Republic of Tanzania and Zambia.

[14] Burundi, Chad, the Congo, the Democratic Republic of the Congo, the Gambia, Guinea, Guinea-Bissau, Malawi, Sao Tome and Principe and Sierra Leone.

35. For countries that have yet to participate under the enhanced HIPC Initiative, the Boards of the International Development Association (IDA) and IMF extended the "sunset clause" under the enhanced Initiative to the end of 2006. IMF and the World Bank have identified 11 countries, including 4 new ones (Eritrea, Haiti, Kyrgyzstan and Nepal), that are potentially eligible under the extended clause. Of the 11 eligible countries, 5 (Comoros, Eritrea, Liberia, Somalia and the Sudan) have yet to start a Fund and IDA-supported programme and would be required to do so before the expiration of the sunset clause. The amount of assistance is estimated to be $21 billion, in 2004 net present value (NPV) terms, for the 11 eligible countries. The largest share, approximately 73 per cent of the total cost,[15] is attributed to the protracted arrears of Liberia, Somalia and the Sudan.

36. In a final push to resolve the debt problem of the poorest countries, in July 2005, the Group of Eight (G8) announced the Multilateral Debt Relief Initiative (MDRI), which provides 100 per cent debt cancellation of claims from IMF, IDA and the African Development Fund for HIPCs that have graduated from the HIPC Initiative. The objective of the G8 proposal is to complete the HIPC debt relief process by freeing additional resources to support countries' efforts to achieve the Millennium Development Goals. It is estimated that MDRI will reduce the NPV debt to export ratio from 140 per cent post-HIPC relief to an approximate 52 per cent.[16]

37. The modalities of eligibility and delivery of the assistance under MDRI will vary among the multilateral organizations. IMF has included two non-HIPCs in the pool of eligible countries to receive debt relief, as it is required to apply the principle of uniformity of treatment across all countries. Accordingly, eligibility for debt relief from IMF will be extended to HIPCs and non-HIPCs with per capita income of $380 or less, to be funded by the profits from the 1999-2000 off-market sales of IMF gold, which will be transferred to a special trust fund, MDRI-I Trust. HIPCs with income levels above that threshold are also eligible to receive the MDRI relief, to be financed from the remaining pool of funds in the MDRI-II Trust received from existing bilateral contributions to the Subsidy Account. Details of the delivery across the three multilateral institutions are summarized below.[17]

[15] IMF, Public Information Notice No. 06/41, 18 April 2006.

[16] Development Committee, Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund, "Note on the G-8 Debt Relief Proposal: Assessment of Costs, Implementation Issues and Financing Options", 21 September 2005.

[17] Based on information posted at varying dates: IMF, May 2006; IDA, June 2006; African Development Fund, April 2006.

**Multilateral Debt Relief Initiative**

| *Organization* | *Presently eligible countries* | *Potentially eligible countries* | *Total estimated cost (billions of United States dollars)* | *Cut-off date* | *Implementation date* | *Delivery period* |
|---|---|---|---|---|---|---|
| IMF | 21[a] | 21 | Over 5 | 1 January 2005 | 5 January 2006 | One time |
| IDA | 19[b] | 21 | 37 | 31 December 2003 | 1 July 2006 | 40 years |
| African Development Fund | 15[c] | 18 | 5.8 | 31 December 2004 | 1 January 2006* | 50 years |

* Will be applied retroactively from July 2006.
[a] Completion point HIPCs plus Cambodia and Tajikistan.
[b] Completion point HIPCs.
[c] African completion point HIPCs.

## B. Assessing the impact of the Heavily Indebted Poor Countries Initiative

38. For the 27 countries that reached the decision and completion points under the enhanced HIPC Initiative by 2004 (the latest year for which data on debt relief are available), the evolution of their debt indicators has shown a clear improvement: the overall ratio of total external debt to GNI declined from 143.0 in 1995 to 115.8 in 2000 and 86.8 in 2004. The nominal stock of debt of the 27 countries was, however, roughly the same in 2004 ($111.1 billion) as in 1995 ($114.7 billion), although the concessionality of debt has increased, in terms of longer maturity and lower interest rates.[18] The percentage share of multilateral debt was also higher (as a great part of bilateral debt has been forgiven). While not all multilateral debt is eligible for cancellation under MDRI, it is expected that completion point countries will benefit from further reduction of their debt.

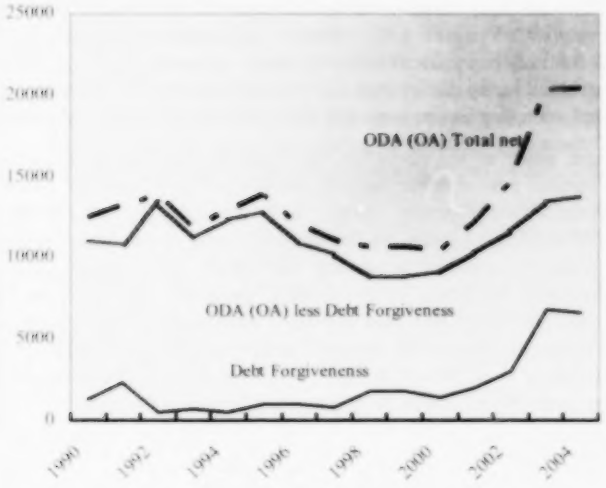
### Additionality

39. A key principle of the enhanced HIPC Initiative was that the provision of debt relief would be used to free additional resources for increased public expenditures, which was based on the understanding that such relief would be in addition to existing aid. In order to measure the additionality of debt relief to aid levels, the volume of aid including debt forgiveness was compared with the volume of aid excluding debt forgiveness.

[18] See UNCTAD, *Trade and Development Report 2006*, chap. III, sect. C, forthcoming.

**Additionality of Debt Relief**

27 HIPC Decision Point Countries, millions of US dollars




*Source*: OECD Development Assistance Committee database 2006.

40. For the 27 HIPC countries having reached decision or completion points by 2004, what is striking is the sharp decline in aid (less debt forgiveness) from the pre-HIPC Initiative levels in 1992 (when no debt relief was recorded) to the low levels in 1999-2000. The trend, which was reversed in 2001, was followed by a continual rise in aid. In 2003 and 2004, the nominal levels of ODA less debt forgiveness were slightly higher than the pre-HIPC level in 1992, revealing, thus, that the increase in ODA in 2004 was mostly attributed to debt relief during those years. The declining and subsequent rising trend of ODA less debt forgiveness certainly raises doubts as to whether the principle of additionality was fulfilled throughout the course of the Initiative.

**Social expenditures/government budget**

41. At the 1999 Annual Meeting of IMF and the World Bank, it was decided to make "country-owned" poverty reduction strategies a basis for future lending and for the implementation of the enhanced HIPC Initiative. Accordingly, aside from the aim of providing debt relief to eliminate the debt overhang of HIPCs, the enhanced Initiative also sought to provide countries with additional fiscal space to increase social expenditures for poverty reduction.

42. For the decision-point HIPCs, since 1999 there has been a rise in poverty reduction expenditures under the enhanced Initiative in parallel to reductions in debt service, as measured as a ratio to government revenue.[19] This is not surprising, as the provision of such expenditures was incorporated into the poverty reduction

[19] Ibid.

strategy paper process. However, despite the increase in those expenditures, the additional resources resulting from debt relief remain below what is needed for those countries to achieve the Millennium Development Goals.

43. Although debt relief has contributed to an increase in social spending, in the end, the Government may simply swap one type of spending commitment (debt service) for another of equal value. Hence, the question arises as to whether countries gain the necessary fiscal space to make optimal policy decisions that are conducive to greater economic growth or whether conditions under the programme create additional spending constraints and liabilities for those Governments.

44. In addition, many of the countries that have reached the decision point under the enhanced Initiative have achieved only modest progress towards achieving some of the Millennium Development Goals, with the majority of countries falling considerably short of the targets set for 2015.[20] As a group, those countries have made some progress towards achieving the goals under gender equality and improved sanitation facilities, with modest progress towards reducing child mortality, although it should be noted that individual country performance is widely varied. Much work remains in the area of hunger, universal primary education and infectious diseases. It is evident that those countries will require a sizeable increase in development assistance in order to achieve the targets set for 2015.

**Debt overhang and growth**

45. The rationale behind the original HIPC Initiative, in 1996, was motivated by the debt overhang literature that asserts that higher levels of debt negatively impact growth and investment.[21] In order to eliminate the debt overhang, the Initiative sought to provide a permanent exit from the repeated debt rescheduling process through the reduction of the stock of debt.

46. Ten years following the launch of the HIPC Initiative, it is clear that it did not succeed in meeting all of its anticipated goals. The process for countries to benefit from the Initiative has proved to be lengthy and slow, and was characterized by complexities that burdened countries' already weak institutions. While the HIPCs as a group have made progress with regard to the performance of a number of debt indicators, such as debt service to exports and debt service to government revenue, the debts of a number of completion point countries have rapidly increased to pre-HIPC levels. According to World Bank estimates, based on 2003 NPV debt ratios of 13 countries for which data is available, the debt ratios of 11 countries have deteriorated and 8 of those countries have exceeded the sustainability thresholds. Moreover, one third of the completion point countries[22] are projected to exceed the sustainability thresholds over the medium term of the post-completion period.[23]

47. In theory, the removal of debt overhang should allow countries to direct the additional resources towards public expenditures aimed at reducing poverty and fostering greater economic growth. Looking at the experiences of the 27 countries

[20] Ibid.

[21] For extensive literature review, see Patillo, Catherine, Helene Poirson and Luca Ricci, "External Debt and Growth", IMF Working Paper WP/02/69, April 2002.

[22] Burkina Faso, Ethiopia, Guyana, Nicaragua, Rwanda and Uganda.

[23] World Bank, "Debt Relief for the Poorest: An Evaluation Update of the HIPC Initiative", Independent Evaluation Group, World Bank, Washington, D.C., 2006, pp. 18-19.

mentioned above, after a steep decline from 1996 to 1999, GDP growth fluctuated from year to year, increasing in 2000, decreasing in 2001, and showing a rising trend from 2002.[24] It is difficult to draw a clear-cut conclusion that the latest increase in GDP growth was made possible by debt reductions, as during that period, countries benefited from the favourable world economic environment and, consequently, buoyant commodities exports. What is encouraging is the steady increase in the average number of commodities exported by the decision point countries, as well as the rising share of exports to GDP when measured as a group. Indeed, those countries experienced the steepest rise in the average number of commodities exported in the period preceding the HIPC Initiative, from 1988 to 1996, which was then followed by positive per capita growth rates.

## C. Financing development beyond the Heavily Indebted Poor Countries Initiative

48. The Millennium Declaration calls for national and international efforts to achieve a comprehensive and effective solution to the debt problems of low and middle-income developing countries, with the aim of making their debt sustainable in the long term. Indeed, there is a clear intention by the international community to avoid another costly round of debt relief. Accordingly, the World Bank and IMF have formulated a framework for prudential lending and borrowing in the future based on the principle of a country's "capacity to pay".

49. The objective of the framework is to operationalize debt sustainability analysis for low-income countries by guiding the decisions of borrowers and creditors based on such considerations as debt burdens and repayment capacity, the "quality" of institutions and policies, and projections of a country's debt dynamics, with the aim to combine rules and discretion in the management of financing decisions.

50. The new framework by IMF and the World Bank[25] identifies debt sustainability thresholds for low-income countries, which vary depending on the strength of institutions and the quality of policies in the country, as measured by the World Bank's Country Policy and Institutional Assessment (CPIA) index. That framework has moved away from the "one size fits all" approach of applying debt indicators and has tailored debt thresholds to more country-specific considerations. While that is clearly an improvement over the unique debt sustainability indicators under the HIPC Initiative, the debt sustainability analysis framework is still open to questions.

51. One concern is the use of benchmarks/thresholds in debt sustainability analysis, which some critics have argued is arbitrary. That approach did not completely address the challenges of HIPC countries and did not prove to be very effective in ensuring that those countries maintained a sustainable level of debt once they reached the completion point. It is questionable as to whether employing a similar method under a slightly different application will have a profound change on the outcome.

[24] *Trade and Development Report 2006*, op cit.

[25] IMF and IDA, "Operational Framework for Debt Sustainability Assessments in Low-Income Countries — Further Considerations", Washington, D.C., 28 March 2005.

52. There is also concern about the accuracy and use of projections of debt burden indicators and the importance of those indicators in lending decisions. It has been pointed out on several occasions that many of the projections applied under the HIPC Initiative proved to be overly optimistic, hence the use of such estimates should be applied cautiously.

53. Another criticism has been expressed about the construction of the CPIA index.[26] The clear motivation behind using the index is to create an incentive mechanism to encourage countries to strengthen their governance/institutions in order to receive greater access to financing for development. The prominence of the index is emerging at a moment when "good governance" has become the latest catchphrase in development economics, especially in relation to the effectiveness of aid. However, it is extremely difficult to measure good governance and institutions. The issue in and of itself is a subjective one, involving concepts that may not universally translate across cultures, hence requiring a great degree of subjective assessment.

54. It is sensible to have a measure of risk assessment when formulating lending decisions, and the promotion of better governance and stronger institutions is justified from that point of view. However, the question posed in this context concerns the accuracy of the measure and its applicability across countries. By and large, the specific method of how the index is calculated has remained opaque and out of the public sphere for scrutiny, thus hindering an informed public debate on the process of assessing governance in developing countries. Moreover, these weaknesses in measurement need to be taken into consideration when deciding how much weight and consideration the index is given in lending decisions, particularly in light of the fact that such decisions determine to a large extent the capacity of a country to pursue its development objectives. Furthermore, there seems to be an inherent moral hazard problem imbedded in the framework, as countries with poor CPIA ranking receive grants and cheaper financing than those with higher ratings, which only receive loans with higher interest.[27]

55. One might also bear in mind the fact that the index is a static measure and does not necessarily reflect the dynamic progress or indicate the direction in which the country's policies are moving (as policies may be reversed and changed in a single year). The ultimate objective is growth and development, which should support debt sustainability in the long run. Governance is perhaps one of the instruments to achieve development. The means therefore should not replace the goal in formulating lending decisions, especially when the means are difficult to measure. Caution and security should be exercised when placing significant weight on such measures.

## Grant financing: is there enough for financing development?

56. In order for countries to achieve the Millennium Development Goals by 2015 without facing debt servicing difficulties, greater grant-based financing is needed

[26] The CPIA index is composed of 20 indicators classified in 4 categories (economic management, structural policies and social inclusion policies, public sector management and institutions) and ranges from 1 to 6.

[27] IDA addresses this contradiction by withholding 20 per cent of the grants to the poor performers, which is then released following improved performance.

for most HIPC countries. However, in cases where additional loans are necessary to finance investment for development, there is a need to promote responsible lending and borrowing and to link the grant element of such loans to the capacity to pay. Within this context, the issue arises as to how a country strikes the proper balance between grants and concessional loans, which will allow a country to achieve its development objectives without risking debt sustainability. It can be envisaged that projects that carry high social value but low financial returns may be funded by grants, while other projects that may generate proceeds more immediately may be financed by loans. The grant element of loans can be made to vary with the potential rates of return of projects.

57. The obvious benefit of using grants is that they will not lead to potential debt servicing problems later on, while providing valuable fiscal space and resources needed to achieve development objectives. In the case of HIPC completion point countries, those countries will not have enough resources to finance development expenditures without significant increases in aid, preferably in the form of grants. While greater reliance on grants is good from the point of view of debt sustainability, there is concern about the availability of future funds and how a significant shift to grants from loans may increase the uncertainty of future aid flows. Furthermore, it is questionable as to whether countries would receive sufficient development financing if they relied solely on grants.

## VI. Policy conclusions

58. The external debt situation of developing countries as a group further improved in the course of last year. A conjunction of external and internal factors contributed to that improvement. Global growth gave a boost to exports from developing countries, allowing foreign exchange reserve build-ups. The low level of interest rates and ample liquidity on international capital markets provided opportunities to raise low-cost capital and to implement active debt management by repaying high-cost debt and prefinancing future capital needs. Developing countries also attracted foreign investors' interest in local currency debt issued on domestic and international capital markets.

59. Yet, this rosy picture should not lead to complacency, as the future is fraught with uncertainty and risks. Central banks in major developed countries have indicated their intention to implement further interest rate increases, in the context of inflationary pressures (in the wake of persistent high oil prices). Global current account imbalances among major trading countries have reached dangerously high, if not unsustainable, levels. An uncoordinated and disorderly resolution of those imbalances may threaten global economic growth, with strong negative impact on exports and GDP growth of developing countries. That may trigger another round of debt crisis.

60. The immediate concern is the risk of reverse capital flows and abrupt withdrawal of those flows from emerging markets. International private capital flows are often characterized by procyclicality, which is dictated by fluctuations in global liquidity and interest rates. Countries have recently built large foreign exchange reserves partly as a way to insure against such capital reflows. However, such reserves may be costly in terms of foregone returns. Other solutions may require the strengthening of regional monetary and financial cooperation, as well as

the development of a stronger base of local and regional institutional investors. The latter are most likely inclined to make long-term investment in local currency debt.

61. The evolution of the international financial system towards a more private-based system of capital flows raises many challenges. Governments should be aware of the procyclicality and volatility of private capital flows and adopt prudential measures accordingly so as to regulate those flows (including adequate supervision of private sector external borrowing), structural reforms of domestic capital markets (to allow better mobilization of domestic savings) and, as mentioned above, stronger regional cooperation.

62. The new international financial architecture of the twenty-first century has provided room for the increasing importance of credit rating agencies. Such agencies play a critical role in the access to international private debt markets by countries and in the determination of the cost of such debt. Given that critical role, more transparency is needed for a better understanding of the rating methodologies used by credit rating agencies. Other issues that may need to be analysed bear upon the enhanced competition and accountability in the profession.

63. The reliance on bond financing also requires consideration for appropriate mechanisms to allow orderly debt restructurings in case of defaults or payments difficulties. As stressed in document A/60/139, the lessons learned from recent experiences of debt restructurings point to the need to reach an international understanding on debt restructuring modalities that would bring together official and private creditors in a collaborative and constructive dialogue with a view to resolving debt problems in an expeditious and timely manner and to protecting the interests of debtors and creditors equitably.

64. Despite a general improvement in the external debt situation, there remains a large number of countries characterized as severely indebted. Innovative approaches could be introduced to allow a larger amount of debt swaps to finance Millennium Development Goal projects in debtor countries. Likewise, the Paris Club Evian Approach can also provide bolder debt reductions for middle-income countries that are heavily indebted.

65. The full implementation of the HIPC and MDR Initiatives may be made more expeditious, in order to allow the remaining eligible countries to benefit from needed debt reductions. Beyond those debt relief initiatives, the question of adequate financing of development of low-income countries needs to be addressed in a flexible way. A substantial scaling up of aid is called for. Consideration could be given to the adequate mixing of grants and loans, varying the grant element according to potential returns of projects. The use of a debt sustainability analysis framework to determine access to finance needs to be applied in a flexible way. Long-term sustainability of debt depends mainly on the growth and export prospects of debtor countries. It follows that debt sustainability analysis should not rely overwhelmingly on governance indicators (which are subjective), but take into account growth and long-term development needs of countries. Strengthening debt-management capacity should be an integral part of debt sustainability strategy.

# Annex

## External debt of developing countries and countries in transition

(Billions of United States dollars)

| | *All developing countries and countries in transition* | | | *Sub-Saharan Africa* | | | *Middle East and North Africa* | | | *Latin America and Caribbean* | | | *East Asia and the Pacific* | | | *South Asia* | | | *Europe and Central Asia* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *2003* | *2004* | *2005[a]* | *2003* | *2004* | *2005[a]* | *2003* | *2004* | *2005[a]* | *2003* | *2004* | *2005[a]* | *2003* | *2004* | *2005[a]* | *2003* | *2004* | *2005[a]* | *2003* | *2004* | *2005[a]* |
| Total debt stocks | 2 581.8 | 2 755.7 | 2 800.4 | 231.2 | 235.1 | 215.6 | 161.2 | 163.9 | 162.5 | 785.9 | 779.0 | 723.7 | 541.5 | 588.9 | 633.7 | 181.5 | 193.9 | 194.8 | 680.5 | 794.9 | 870.1 |
| Long-term debt | 2 054.1 | 2 164.9 | 2 194.5 | 194.2 | 196.6 | 180.6 | 137.9 | 141.0 | 139.2 | 649.6 | 639.3 | 620.7 | 388.7 | 403.1 | 417.9 | 171.5 | 181.2 | 179.8 | 512.3 | 603.7 | 656.3 |
| Public and publicly guaranteed | 1 451.0 | 1 493.4 | 1 433.7 | 178.8 | 182.0 | 165.4 | 130.9 | 133.9 | 128.9 | 426.3 | 433.3 | 414.5 | 266.4 | 269.6 | 271.2 | 147.6 | 152.9 | 145.6 | 301.0 | 321.7 | 308.1 |
| Private non-guaranteed | 603.1 | 671.5 | 760.8 | 15.4 | 14.6 | 15.3 | 7.0 | 7.2 | 10.3 | 223.2 | 206.0 | 206.3 | 122.3 | 133.5 | 146.6 | 23.9 | 28.3 | 34.2 | 211.3 | 281.9 | 348.1 |
| Short-term debt | 420.8 | 494.8 | 556.7 | 29.8 | 31.2 | 29.0 | 21.4 | 21.5 | 22.4 | 88.6 | 96.3 | 91.0 | 140.6 | 174.8 | 207.2 | 7.4 | 10.3 | 12.8 | 133.0 | 160.5 | 194.2 |
| Arrears | 128.5 | 141.1 | 110.8 | 43.1 | 42.3 | 35.7 | 15.6 | 16.4 | 16.3 | 32.8 | 49.4 | 25.7 | 23.3 | 24.4 | 24.5 | 0.0 | 0.0 | 0.0 | 13.7 | 8.6 | 8.5 |
| Interest arrears | 46.4 | 50.3 | 38.1 | 15.7 | 16.1 | 12.5 | 2.8 | 2.9 | 2.9 | 13.9 | 18.8 | 10.3 | 8.4 | 8.5 | 8.5 | 0.0 | 0.0 | 0.0 | 5.5 | 4.0 | 4.0 |
| Principal arrears | 82.1 | 90.8 | 72.6 | 27.4 | 26.2 | 23.2 | 12.8 | 13.5 | 13.4 | 18.9 | 30.6 | 15.4 | 14.8 | 15.9 | 16.1 | 0.0 | 0.0 | 0.0 | 8.2 | 4.6 | 4.5 |
| Debt service paid | 420.4 | 450.3 | 510.8 | 12.6 | 13.8 | 23.4 | 20.9 | 21.7 | 21.1 | 153.2 | 156.7 | 177.5 | 92.1 | 78.8 | 82.1 | 24.9 | 25.0 | 25.8 | 116.7 | 154.3 | 180.0 |
| Gross national income | 6 901.9 | 8 126.0 | | 403.6 | 486.7 | | 436.1 | 491.1 | | 1 693.8 | 1 940.6 | | 2 256.9 | 2 622.1 | | 757.8 | 860.8 | | 1 358.5 | 1 717.3 | |
| International reserves | 1 277.7 | 1 684.4 | | 41.4 | 63.4 | | 97.7 | 112.3 | | 200.8 | 226.7 | | 566.2 | 803.1 | | 122.3 | 149.9 | | 249.3 | 328.9 | |
| **Debt indicators (percentage)** | | | | | | | | | | | | | | | | | | | | | |
| Debt service/exports of goods and services | 17.3 | 14.3 | | 8.7 | 7.9 | | 12.6 | 10.6 | | 31.3 | 26.4 | | 10.4 | 6.8 | | 16.7 | 12.4 | | 19.8 | 15.1 | |
| Total debt/exports of goods and services | 106.3 | 88.6 | | 159.5 | 134.8 | | 97.2 | 80.3 | | 160.5 | 131.2 | | 61.3 | 51.0 | | 121.6 | 90.6 | | 111.2 | 95.1 | |
| Debt service/GNI | 6.1 | 5.5 | | 3.1 | 2.8 | | 4.8 | 4.4 | | 9.0 | 8.1 | | 4.1 | 3.0 | | 3.3 | 2.9 | | 8.6 | 9.0 | |
| Total debt/GNI | 37.4 | 33.9 | | 57.3 | 48.3 | | 37.0 | 33.4 | | 46.4 | 40.1 | | 24.0 | 22.5 | | 24.0 | 22.4 | | 50.1 | 46.3 | |
| Short-term/reserves | 32.9 | 29.4 | | 71.8 | 49.1 | | 21.9 | 19.2 | | 44.1 | 42.5 | | 24.8 | 21.8 | | 6.1 | 6.9 | | 53.3 | 48.8 | |

*Source*: World Bank, *Global Development Finance 2006*, online database.

[a] Estimated.